BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

June 16, 2005

The Honorable John Sununu
United States Senate
Washington, D.C. 20510

Dear Senator:

Thank you for your letter of June 13 seeking suggestions to improve S. 190, the bill you have introduced with Senators Hagel and Dole. As I testified before the Congress both this year and in 2004, the government-sponsored enterprises (GSEs) need a regulator with authority on par with that of banking regulators, including a free hand to set appropriate capital standards and a clear and credible process sanctioned by the Congress for placing a GSE in receivership. However, if legislation takes only these actions and does not limit GSE investment portfolios, we run the risk of solidifying investors' perception that the GSEs are instruments of the government and that their debt is equivalent to government debt.

Without effective portfolio limits, the GSEs will have an increased facility to continue to grow faster than the overall home-mortgage market; indeed, because their portfolios are not constrained by law to home mortgages, GSEs can grow virtually without limit. GSEs' mortgage securitization, in contrast to their portfolio holdings, is the key to maintaining and enhancing the benefits of Fannie Mae and Freddie Mac to homebuyers and the secondary mortgage markets. And mortgage securitization, unlike the GSE portfolio holdings, does not create substantial systemic risks.

One way to limit the GSE portfolios is to require that the GSEs demonstrate to their regulator that any asset held in their portfolios furthers their affordable housing or secondary market liquidity objectives and could not have been securitized and sold to others. The Secretary of the Treasury has proposed legislative language that implements these sorts of limits, which he has shared with members of the Senate, and we at the Federal Reserve Board fully support his proposal. With the addition of this language to S. 190, the potential for systemic risk would be significantly reduced.

By using market-subsidized debt, Fannie and Freddie are able to grow and expand essentially without bounds and thereby concentrate the management of interest rate risk from mortgages. As I stated in a speech on May 19, 2005:

As Fannie and Freddie increase in size relative to the counterparties to their hedging transactions, the ability of these GSEs to quickly correct a misjudgment in their complex hedging strategies becomes more difficult, especially when vast reversal transactions are required to rebalance portfolio risks. We are thus highly dependent on the risk-managers at Fannie and Freddie to do everything right. Moreover, the success of interest-rate-risk management, especially the exceptionally rapid timing required by dynamic risk adjustments, requires that the ultimate counterparties to the GSEs' transactions provide sufficient liquidity to finance an interest-rate-risk transfer that counters the risk. Otherwise, large and rapid dynamic adjustments will result in sharp changes in the prices for rebalancing and hedging a mortgage portfolio. The consequence would be added to interest rate volatility.

In the end, we cannot eliminate the risk inherent in mortgages with refinancing options. But we can markedly contain the accompanying risks to systemic stability by diversifying the concentration of risk away from large, highly leveraged portfolios for which misjudgments can have quick and devastating consequences. A system of diversified and less-leveraged interest-rate-risk management would be far more resilient to the inevitable mistakes and shocks of individual risk-mitigating strategies. Such diversification would thus pose much less systemic risk, largely because of lowered leverage, which in turn is the consequence of the private-market discipline imposed on commercial and investment banks, mutual funds, insurance companies, and other current or potential holders of mortgage-backed securities.

The statutory restrictions on GSE portfolios proposed by the Secretary of the Treasury would limit the GSEs portfolios to mission-related investments and effectively place the interest-rate-risk management of mortgages into the hands of a more diverse range of private sector firms. The potential for systemic problems would be greatly reduced.

You also inquired about my views concerning a recent report by Federal Reserve staff entitled, "Concentration and Risk in the OTC Markets for U.S. Dollar Interest Rate Options." This report concluded that although dealer concentration raises the possibility of problems such as market illiquidity, market risks to dealers and counterparty credit risks, most market participants are aware of such concerns and engage in risk-management practices designed to mitigate such potential problems. I, and I gather my colleagues on the Federal Reserve Board, fully agree with the conclusions of that report. The conclusions, however, in no way assuage the concerns about the GSEs' threat to the stability of our financial system. Indeed, as described in the report, the GSEs' large positions in derivatives markets create a substantial risk-management challenge for markets participants in the interest-rate-options markets. This challenge is but one small element of our much larger concern about GSEs--that their ever increasing size creates significant systemic risks for our financial system.

Recently, we released this report on the markets for interest rate options to the public. The Federal Reserve often studies financial markets issues by interviewing and obtaining data from market participants. Many of these firms, including Fannie and Freddie, participate in these studies only because they believe that the information provided to the Federal Reserve will be kept confidential. Thus, we do not normally release the results of such a study because participants respond more fully and candidly when they believe the information will be kept confidential. However, it is our standard practice to provide a summary of the results to the participants in the study, with the understanding that the summary is not to be circulated to others. It is unfortunate that the summary, which was promised to be held confidentially, was selectively made public by another party. Once this occurred, we decided that we could no longer hold the information confidential from all other interested parties and thus we made the report public. I sincerely hope this transgression does not discourage market participants from providing us with confidential information going forward, thus compromising our ability to undertake such important studies in the future.

Thank you for the opportunity to express my views on these important matters.

Sincerely,